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Chinese Investment in the U.S.: $2 Trillion and Counting

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Chinese investment in the U.S. is commonly misunderstood, both the size of holdings and the forces behind them. Most Members of Congress would put Chinese investment in the U.S. at about $900 billion. This is too low by $1 trillion and possibly more. Many participants in financial markets would fret over the PRC potentially choosing to disinvest from the American economy. This seems reasonable; however, it is essentially impossible.

The Department of the Treasury just issued its preliminary annual report of foreign holdings of American securities. It puts total Chinese investment in the U.S. at $1.61 trillion as of June 30, 2010.[1] This is not entirely accurate, but it is far better than the figures in the unrevised monthly Treasury reports used by Congress and the media. To illustrate: the total given for China's Treasury position was previously $844 billion in June 2010. Upon revision, it is $1.11 trillion.

There are two problems. First, the amount of U.S. dollar assets held by the PRC is obscured by poor numbers. Second, there are widespread misconceptions of why China holds dollars. It does so due to its balance of payments system. Until Beijing changes its own rules—which it so far has declined under intense foreign pressure—it has no choice but to buy. Disinvestment cannot occur.

Flawed American Numbers. Congress and the public rely on Treasury's monthly series on major foreign holders of its bonds, which previously put China's total at $892 billion at the end of 2010. This was misleading in four ways:[2]

1. It obscured more than $250 billion in Chinese purchases made via Britain, Hong Kong, and offshore sources, such as the Cayman Islands.
2. It excluded at least $300 billion in purchases of agency bonds from Fannie Mae and Freddie Mac held through the end of 2010.
3. It excluded more than $125 billion in purchases of stocks and short-term debt.
4. It excluded dollars held outside securities, such as in Chinese and other banks.

Treasury's annual report addresses the first three problems. It traces some indirect buying, especially through Britain. It includes agency debt. The annual report also includes estimates of other Chinese holdings, as in U.S. stocks. The headline figure of $1.61 trillion is a much more accurate number than $892 billion.

In the annual report, Treasury uses a more complete survey than the monthly report. Unfortunately, the annual survey is not frequent enough. It is eight months out-of-date upon release and 20 months out-of-date before being revised. Like the inaccurate

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monthly series, the annual report cannot be used to ascertain whether the PRC is currently buying or selling bonds. Other limitations of the annual survey include failure to attribute all indirect buying; for example, the Caymans were said to invest $732 billion. It does not measure simple bank deposits denominated in dollars. These are not as important as investments but may involve large sums.

Flawed Chinese Numbers. Chinese figures shed additional light on the true nature of the purchases: They are not choices to be unraveled at any time; they are the unavoidable outcome of China's balance-of-payments regime.

The PRC's official foreign exchange reserves stood at $2.85 trillion last year. Remarkably, total Chinese foreign currency holdings are even larger. The domestic banking system appears to have held almost $400 billion more in foreign exchange at the end of 2010, though no such figure can be confirmed.[3] A low figure for the country's total foreign exchange holdings is therefore better estimated at $3.25 trillion.

A higher estimate, also using official data, puts total foreign exchange in the banking system at more than $3.4 trillion.[4] Sovereign wealth fund China Investment Corp. was originally granted $200 billion in foreign exchange, though its present assets are unclear. Finally, deposits held overseas by Chinese entities outside the central government are excluded. It is possible total Chinese holdings exceed $3.6 trillion.

There is no official Chinese figure for total holdings, or for the dollar's share in those holdings. The lowest estimate of the dollar share is about 58 percent. The highest is an official figure for the dollar share of China's debt: 72 percent. Chinese dollar holdings therefore most likely ranged from $1.9 trillion to $2.6 trillion at the end of 2010. A recent estimate by Federal Reserve Chairman Ben Bernanke of $2 trillion, which seems to have surprised the Congress as high, may in fact be too low.[5] (See Chart 1.)

Beijing's True Options. This may sound apocalyptic to some. If $900 billion in purchases was a sign of Chinese influence, $2 trillion is far worse. In fact, the huge figure indicates the opposite: China holds all those dollars because it has no choice.

The PRC cannot spend foreign currency at home. The state controls the entire financial system, and foreign currency cannot be invested overseas by citizens. Any attempt to spend foreign exchange at home—for instance, to build hospitals—returns the currency to the state. When pressed, senior Chinese officials acknowledge this.[6]

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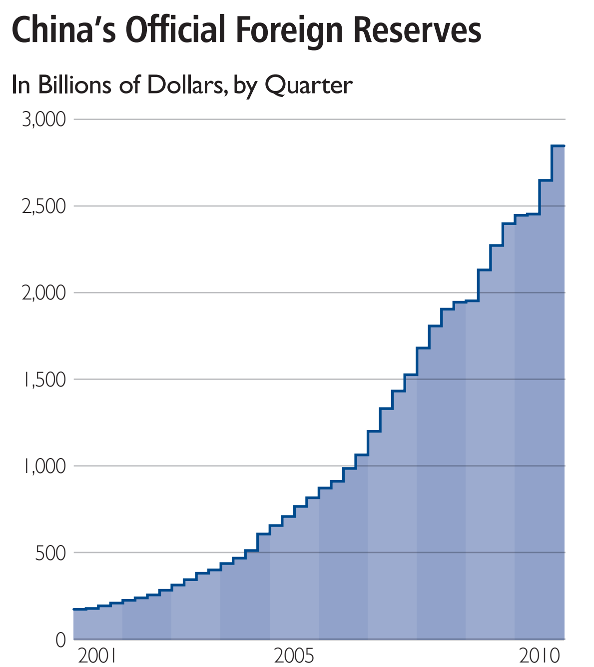
1. U.S. Department of the Treasury, *Preliminary Report on Foreign Holdings of U.S. Securities at End-June 2010*, February 28, 2011, at *http://www.treasury.gov/press-center/press-releases/Pages/tg1079.aspx* (February 28, 2011).
2. Derek Scissors, "China's Treasury Bond Holdings Rose, Not Fell," The Foundry, February 15, 2011, at *http://blog.heritage.org/2011/02/15/china%E2%80%99s-treasury-bond-holdings-rose-not-fell*; U.S. Department of the Treasury, *Foreign Purchases and Sales of Long-Term Domestic and Foreign Securities by Type for China, Mainland*, February 28, 2011, at *http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/s1_41408.txt* (February 28, 2011); and The People's Bank of China, *Financial Statistics, November 2010*, December 30, 2010, at *http://www.pbc.gov.cn/publish/english/955/2010/20101228160720355427287/20101228160720355427287_.html* (February 24, 2011).
3. Li Jia, "China's Foreign Exchange Reserves Top 2.8 Trillion USD in 2010," *People's Daily Online*, January 12, 2011, at *http://english.peopledaily.com.cn/90001/90778/7258242.html* (February 24, 2011), and "Chinese Banks' 2010 Forex Surplus Tops 397.7 Bln USD: SAFE," *Xinhua*, January 28, 2011, at *http://english.peopledaily.com.cn/90001/90778/7274984.html* (February 24, 2011).
4. "Update: China Banking System's Dec Net Forex Purchases CNY 403.3 Bln," *Dow Jones*, January 18, 2011, at *http://online.wsj.com/article/BT-CO-20110118-707985.html* (February 24, 2011).
5. Andrew Batson, "China's Reserves Already Divers, Citi Says," *China Real Time Report*, September 9, 2010, at *http://blogs.wsj.com/chinarealtime/2010/09/09/chinas-reserves-already-diverse-citi-says* (February 24, 2011); "China's External Debt Reaches 546.4 Bln U.S. Dollars by Last Sept.," *Xinhua*, January 19, 2011, at *http://news.xinhuanet.com/english2010/china/2011-01/19/c_13698193.htm* (February 24, 2011); and Colin Barr, "Our Dollar, China's $2 Trillion Problem," *Fortune*, February 9, 2011, at *http://finance.fortune.cnn.com/2011/02/09/our-dollar-chinas-2-trillion-problem* (February 24, 2011). If Beijing were to let the yuan climb 30 percent against the dollar, it would cut the yuan value of China's dollar holdings by over $600 billion.



Source: National Bureau of Statistics, China Monthly Statistics, Beijing, Vol. 3, 2001 to Vol. 1, 2011.

Chart 1 • WM 3169 heritage.org

Foreign currency in banks, either to finance commercial activities or simple deposits, accounts for some holdings outside official reserves. However, that leaves perhaps $3 trillion invested overseas. The number is soaring: the balance-of-payments surplus has averaged almost $400 billion annually the past four years. This is after China buys all its oil, iron, gold, and so on. Outside bonds, China's outward investment is $55 billion to $60 billion annually—sizable, but only 15 percent of the required outlay.[7] This includes all the purchases of stocks and other assets foreign countries have allowed.

Where does the rest go? There is no European bond market, and most national euro-denominated bond markets are underdeveloped. The PRC's holdings of Japanese government bonds are comparatively minor and may be shrinking.[8] Almost all other bond markets are too small. Only one market is large enough to absorb all that money: the U.S.

If China were running $150 billion annual surpluses, it could avoid investing in the U.S. If it changed its balance-of-payments rules to greatly loosen state control, as Washington wants, it could avoid investing in the U.S. At $400 billion annually and unable to use the money at home, it must allocate huge amounts to American bonds. The amount is so large because there is nothing else for China to do.

Better Data Make Better Policy. There is far more Chinese money in the U.S. than is commonly understood, yet no disaster has occurred. This is partly because of the depth of American financial markets, but also because the PRC cannot disinvest under its huge external surpluses and rigid balance-of-payments rules. The actual lesson of $1.6 trillion in June 2010 (and counting) is no Chinese financial influence over America.

Misconceptions are caused in part by incomplete data. Moreover, when conditions finally change, Chinese funds must be monitored better. Most important, the PRC is not just pegged to the dollar, it is dependent upon it. Addressing that dependence will yield a more open China. To encourage the transition to a more open China, the U.S. should:

- ***Improve Data Collection.*** The annual Treasury survey is a weighty undertaking but perhaps could be made semi-annual. If not, a more limited quarterly or monthly survey superior to the monthly foreign holders series should be created. Congress needs better information, and Treasury should provide it.

6. Derek Scissors, "China is a Banker Over a Barrel," *Washington Examiner*, March 14, 2009, at *http://dev.www.washingtonexaminer.com/opinion/columns/Sunday_Reflections/China-is-a-banker-over-a-barrel-41252887.html* (February 24, 2011), and Andrew Batson, "Beijing Reveals Small Parts of Big Stimulus," *The Wall Street Journal*, November 15, 2008, at *http://online.wsj.com/article/SB122670803014529937.html* (February 24, 2011).
7. National Bureau of Statistics, China Monthly Statistics, Beijing, Vol. 3, 2008, to Vol. 1, 2011, and Derek Scissors, "China Global Investment Tracker," Heritage Foundation *White Paper*, January 10, 2011, at *http://www.heritage.org/research/reports/2011/01/china-global-investment-tracker-2011*.
8. Yoshiaki Nohara and Shigeki Nozawa, "China Sells Japanese Government Debt After Yen, Benchmark Bonds," *Bloomberg*, February 7, 2011, at *http://www.bloomberg.com/news/2011-02-08/china-sells-japanese-debt-after-yen-benchmark-bonds-declined.html* (February 24, 2011).

- ***Offer Mutually Beneficial Cooperation.*** The U.S. should encourage China to address dollar dependence. Led by Treasury and including the Department of State and the White House, the U.S. should offer technical assistance and extensive financial cooperation in case of any instability. This could be coupled with reciprocal Chinese cooperation in other areas.

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